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THE BEST OPTION STRATEGIES

A "Hands On" Guide to Making Money with Options

Volume 0

INTRODUCTION TO OPTIONS THE BASICS

MARK D WOLFINGER

The Best Option Strategies: A "Hands On" Guide to Making Money with Options

Volume 0

Introduction to Options: The Basics

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Mark D Wolfinger

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This is Book ONE in a series of educational and informative books for option traders.

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About the Author

Read my blog, written primarily for rookies, or follow me on Twitter.

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Introduction

Learning to trade options is a very personal undertaking. Over the years poor publicity has convinced some people that options are inherently risky instruments. It is not true. The major risk with options occurs when they are used by unprepared, overconfident traders.

Those with an appropriate mindset –"options may prove useful, but first I must determine how well I can understand how they work"—have the best chance of finding success.

This eBook is offered to give you a taste

of the world of stock options. There's enough information to help you decide whether you want to learn more. If the answer is "yes" then use the links to additional information.

The language of options is introduced. Words that may be unfamiliar are kept to a minimum. The first time these words appear, they are underlined in bold font. There is a Glossary at the back of the book. Additional option terminology is available in an expanded glossary.

Your study of this subject can be as simple or complex as you desire. If your goal is to learn enough to own positions that enhance your income potential –

with reduce risk, then you can achieve that goal by understanding how to write covered calls or sell cash-secured puts. Lessons on how to adopt those strategies are beyond the scope of this short introduction to options, but the information is available in any good introductory options book.

The purpose of this booklet is to provide the most basic introduction, and everything is presented at the introductory level. In other words, this is a taste of how to use options

Let’s get started.

Chapter 1

What is An Option?

An option is an agreement, or a contract, between two people: The buyer and the seller. The buyer pays a negotiated price to the seller, and that price is referred to as the **premium**. The "negotiations" occur on the trading floor of one of the (currently) 12 US options exchanges when you enter a limit order through your broker to buy or sell an option. When another party (probably a market maker) accepts your price, then the trade is made. This is exactly the same procedure used to trade stocks.

There are two types of options: **calls** and

puts.

A call option gives its owner is the **right** to buy (and a put option gives its owner the right to sell):

- A specific item (the **underlying asset**)
- At a specific price (**strike price**)
- For a specific time (until the option **expires**).

That is all there is to an option. It is not complicated.

If you ever received a rain check at a supermarket, then you have used a call option. The rain check offers a customer the right to return to the store (within a limited time) to buy a specific item at a sale price.

The premium is zero, because the rain check is given to the customer. In the

world of stock options, the premium is never zero.

The underlying asset is the item you want to buy and is specified in the written rain check.

The strike price is the actual price paid to buy the item. NOTE: The strike price is *not* the premium. **Paying the premium gives you the right to buy the item by paying the strike price.**

Expiration is the last day the rain check is valid.

Rain checks are very simple items. Call options are no more complicated than that.

Chapter 2

How Does An Option Work?

When trading, you can either buy or sell options. An option owner acquires some **rights**. That should seem logical because it costs money to buy an option.

An option seller takes on **obligations**. This too should seem reasonable. The seller has been paid a cash premium and may be called upon to fulfill the terms of the option contract. The seller was not paid that cash as a gift, and that means he/she may have to satisfy those obligations.

NOTE: Part of the time the option owner

makes the decision to allow his/her rights – along with the seller's obligations – to expire unused. Thus, part of the time the seller is not called upon to honor those obligations.

A call owner has the right to buy the underlying by paying the strike price. But, he/she does not have to do so. There is no obligation. If the option owner chooses to do what the contract allows, then he/she is said to **exercise** the option.

An option seller has no control over when, or if, the option owner exercises. If the owner does exercise, then a seller of that specific option (chosen at random

from among all the traders who sold that same option) is **assigned an exercise notice** and is obligated to honor the conditions of the contract:

- The call seller must sell 100 shares of stock at the strike price per share, if assigned an exercise notice.

- The put seller must buy 100 shares of stock at the strike price, if assigned an exercise notice.

How does a call option work in our everyday lives?

When returning to the supermarket to use

the rain check, you exercise the call option. When you hand the rain check to the cashier that is the store owner's notification that he/she has been assigned an exercise notice and must sell the underlying at the strike price.

When you own an option, what can you do with it?

You have three choices:

- Sell the option.
- Allow it to **expire worthless**.
- Exercise the option to either buy or sell stock.

As with all trading situations, once you own an asset, it is yours to do with as you please. The most popular choice is to sell an asset (when you no longer want to own it) to lock in a profit or loss. Options work just that way.

If you hold onto an option too long and expiration nears, that option may have no residual value and there may be no one willing to bid anything to buy it. When there are no buyers, you cannot sell and must hold onto the option. Once expiration arrives and the option is **out of the money**, that option becomes worthless. The option is removed from your account -- the equivalent of selling

the option at zero.

NOTE: A call option is out of the money (OTM) when the strike price is above the stock price. A put option is out of the money when the

strike price is below the stock price.

The option owner always has the right to exercise any American style (the typical stock option is American style) option that you own. However, for practical reasons, this will seldom be your best choice. It is almost always better to sell the option when you no longer want to own it. The exception occurs when you prefer to take a position in the underlying stock, rather than collecting cash for the option.

If you have a rain check from a store, you can return to buy the sale item (exercise a call option) or just forget about it and toss it in the trash (let it expire worthless). Sure, you can try to sell it, but it will be difficult to find a buyer (this rain check is a very illiquid asset). When you trade stock options, there are marketplaces where there are always buyers and sellers – except when an option is worth so little that no one is willing to bid anything to buy it.

Why allow an option to become worthless?

If you have the right to buy stock at the strike price (for example, $30 per share) and the stock is available at a lower price – for example, $29 – it makes no sense to exercise your call option to pay $30 when you can save money by buying stock at $29 and ignoring the option. Some beginners miss this simple point: There is no obligation to exercise. An option owner is in control of all decisions and may sell (if there is a bidder), exercise, or allow the option to expire unused.

Chapter 3

Buying Selling, Exercising Options

When using options in the stock market, the underlying asset is 100 shares of a specific stock or exchange-traded fund (ETF). Options are also available on some broad-based indexes.

When entering an order to buy or sell options, your broker electronically sends the order to one of the option exchanges where the order is executed. This is essentially the same method used to buy or sell stock.

If you ever elect to exercise an option,

notify your broker, who takes care of the rest of the process. There is nothing else for the option owner to do – it is an automatic process once you exercise the option.

If you sell an option and later are assigned an exercise notice, you are notified about this transaction (it is a transaction because when assigned, you

either buy or sell stock at the strike price) by your broker.

The notification arrives before the market opens the next trading day. The assignment occurs overnight.

If you are assigned an exercise notice on a call option, 100 shares will have been removed from your account and replaced with cash (100 * strike price; less commissions) by the time you see your account information on the following business day. It is the same as if you sold 100 shares overnight.

If assigned on a put option, 100 shares appear in your account and the cash to

pay for those shares (plus commissions) has been removed. Again, you bought 100 shares while the markets were closed.

In other words, there is no advance notice of a pending assignment. Once you are notified, the assignment is permanent (it cannot be reversed without making an additional stock trade to offset the assignment).

Most exercises and assignments occur at expiration, but it is possible for an option owner to exercise an option prior to expiration. It does not happen very often, but there is one exception when a call option is deep in the money.

Sometimes an option is exercised one day before the stock goes ex-dividend. That happens because option owners do not collect dividends. Only stockholders do. Thus, the call owner who wants the dividend must exercise the option and convert it to stock.

Chapter 4

Getting Started

You must open a brokerage account before being allowed to trade options. If you don't already have one, several good brokers are available. Here is a site that I recommend for finding a broker.

Because trading options is not for everyone, it is a good idea to read an educational pamphlet before you begin trading. Your broker will send a copy, but it is available as an online download: Characteristics and Risks of Standardized Options. It is published by the OCC (Options Clearing

Corporation).

You must also open a margin account. Don't let this concern you, because it is a requirement for trading options. A margin account allows traders to borrow money from their broker, but you may trade as if you have a regular cash account, and there is no obligation to use margin.

I trust that it is unnecessary to mention, but be sure that you have some idea of what you are doing before entering into any trades. The contents of this eBook may provide good background, but it is not enough for anyone. I urge you to read more and/or attend free educational

webinars offered by your broker, the Options Industry Council, or the CBOE.

Chapter 5

Option Books

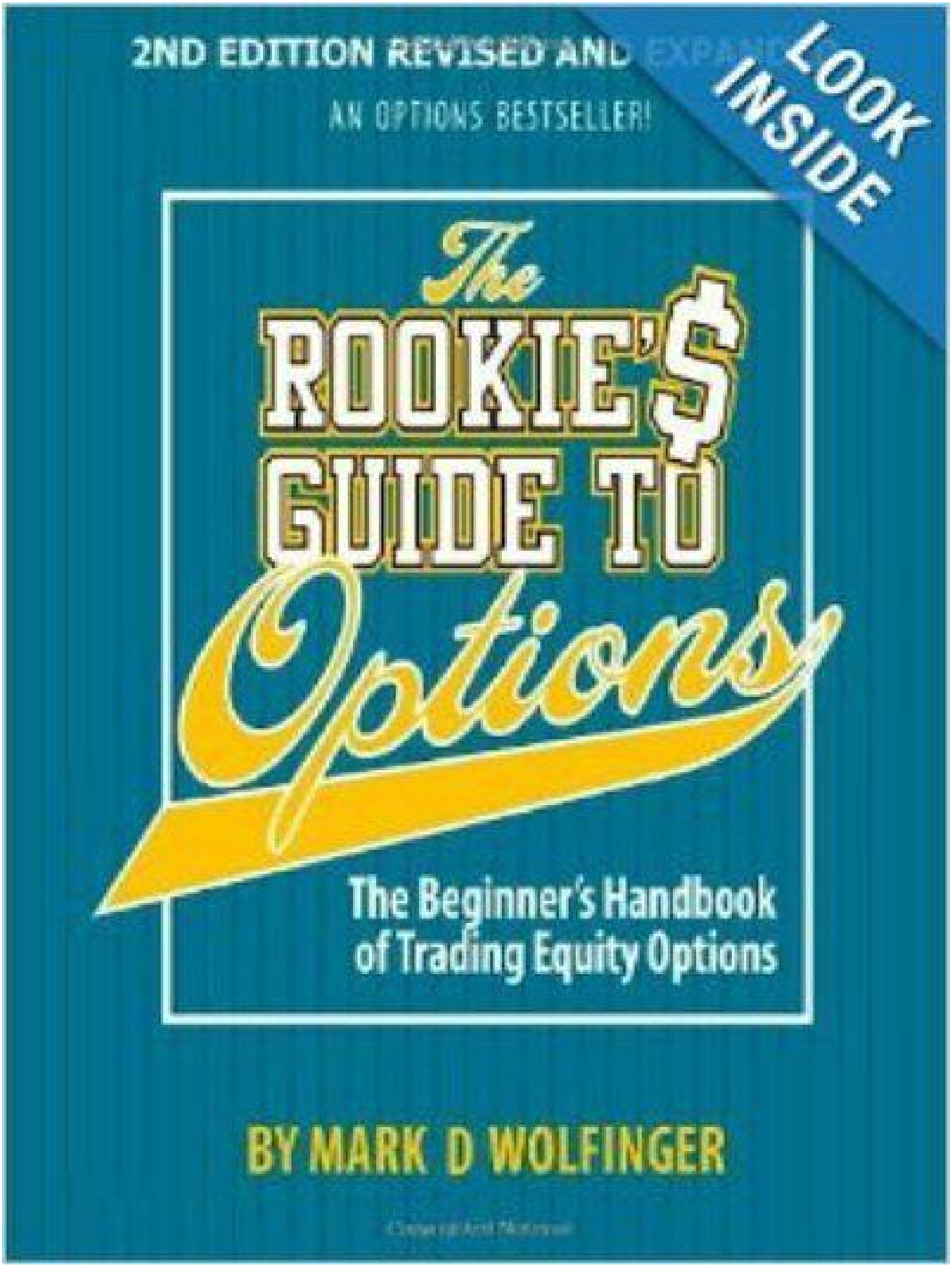
To learn more about options, there are many books on the subject. Visit your local library or favorite bookstore.

I've written three dead-tree books specifically for the options beginner. The Rookie's Guide is the one that I recommend.

- The Rookies Guide to Options, 2nd Edition (2013)
- Create your own Hedge Fund (2005)
- The Short Book on Options (2002)

My eBooks:

- Iron Condors
- Writing Naked Puts
- The Short Book on Options
- The Option Trader's Mindset: Think Like a Winner
- Lessons of a Lifetime: My 33 years as an Option Trader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The
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Options
The Beginner's Handbook of Trading Equity Options
BY MARK D WOLFINGER

Chapter 6

Market Quotes

When trading options, a source of live option quotes is required, and your broker should provide them. If that doesn't work for you, get delayed quotes from one of the option exchanges.

I recommend the CBOE website.

Delayed quotes are fine for making practice trades. But please use live, up-to-the-second real quotes when making a trade.

TIP: Do not pay the asking price when buying options. Do not sell the bid price when selling options. Try to get a better price for your trade executions. Suggestion: Find the midpoint between the bid and ask quotes and enter an order that is near that midpoint. If, for example, the market is $1.00 bid//$1.30 ask, then try to sell $1.10 or try to buy @ $1.20

Chapter 7

What is an Option Worth?

An option can be described in mathematical terms and it is possible to calculate a theoretical, or fair, value for any option. Fortunately it not necessary to get involved with the math because calculators are readily available and they do all the work.

One such calculator can be found at the CBOE.

To use the calculator, you must input certain data:

- Stock Price

- Strike Price
- Interest Rate
- Dividend
- Time (in days) remaining before expiration
- Option type (call or put)
- Volatility

The only one of these items whose value is unknown is "volatility." In simple terms volatility is a measure of the tendency of a stock to undergo price change. Stocks that have frequent, large price changes (measured as a percentage, not in points. In other words, a 1-point change in a $20 stock represents the same volatility as a 10-point change in a $200 stock. The

options of volatile stocks trade at much higher prices (premium) than options of stocks that are less volatile.

Why? The option buyer makes money when the stock undergoes a large price change. More volatile stocks are far more unlikely to undergo such a price change than non-volatile stocks. Translation: People are willing to pay more when buying options on volatile stocks and sellers demand more when selling those options.

The problem is that we can never know the future volatility of any stock. The best we can do is to estimate that future volatility based on past (historical)

volatility. Regardless of how that volatility number is determined, it is always an estimate -- and all numbers generated by the calculator are approximate. The numbers are reasonable, but they are not exact.

Understanding volatility is essential to options traders. If you continue your options education, please do not ignore this topic.

Chapter 8

Option Strategies

Options are versatile investment tools and there are many ways to use them. Some methods are highly speculative. Some are conservative. I recommended learning conservative strategies, especially at the beginning of your option-trading career. Later, if you must, you can attempt more aggressive methods.

I believe that conservative strategies are beneficial in helping the average individual investor earn additional profits from an investment portfolio. Thus, I limit the lessons that I teach to

strategies that come with limited risk. Those strategies fall under the category of "**spreads.**"

You can find detailed instruction on how to adopt and manage my favorite strategies in *The Rookie's Guide to Options*. Or you can visit my blog and get started with discussions on various strategies.

The strategies I used most often during my trading career include:

- Writing covered calls
- Selling naked Puts
- Credit and debit spreads (Vertical spreads)

- Calendar Spreads
- Iron Condors

This list is not exhaustive because there are many more strategies that traders may decide to trade. Some are appropriate for new option traders and others are seldom used by anyone other than professional traders.

Once you learn a few strategies, you will have an excellent idea as to the type of strategy that best suits your investing objectives, your tolerance for risk, and most importantly, your own character traits (i.e., lack of greed and good discipline). However, any discussion of those strategies is beyond the scope of

this book.

One point is worth mentioning: The strategy does not make money for the trader. It is the trader's ability to adopt the strategy and to make good decisions that "make the money." Knowing when to enter, exit and actively change the position to reduce (or eliminate) risk – those are the skills that earn the money.

Chapter 9

Conclusion

The material presented in this eBook is meant to be an introduction to the options universe. If this is your first encounter with options, you have much to learn before being ready to put real money into play.

I must mention one idea that goes well beyond this book: Risk management. You can learn to trade options effectively and you can earn money doing so. However, if you do not pay careful attention to what can go wrong and if you do not practice sound risk management, then the losing trades can overwhelm your

winning trades and destroy your trading account.

What comes next?

Continue to read and learn. Open a paper trading (practice) account with your broker so that you can gain experience using play money.

More options education is available:

- Online resources
- Library
- Bookstore
- Ask your broker

This information is provided with the

sincere hope that readers will want to learn more about the intelligent use of options.

Good trading to everyone!

Glossary

Premium — cost (or sale price) of an option

Call — an option contract giving its owner the right to buy the underlying asset at the strike price before expiration

Put — an option contract giving its owner the right to sell the underlying at the strike price for a specified period of

time

Underlying – asset that the call owner has the right to buy and the put owner has the right to sell

Strike Price — price at which the option owner may buy or sell the underlying

Expiration — the date, after which an option is no longer a valid contract

Rights — attributes acquired by the option owner in return for paying the premium

Obligations— requirements accepted by

the option seller in return for receiving the premium

Exercise — process by which an option owner does what the contract allows

Assigned (or assigned an exercise notice) —Notification that the option owner has exercised rights and you (the option seller) are required to fulfill the conditions of the contract

Spread — A hedged (reduced risk) position in which one option is bought and another is sold. Profits and losses are limited.

Out of the money (OTM) — A

situation in which an option has no intrinsic value, but whose value is based on the possibility that the underlying stock will make a favorable move before it expires. A call is OTM when the strike price is above the stock price; a put is OTM when the strike price is below the stock price.

In the money (ITM) — The option has intrinsic value. A call is ITM when the strike is below the stock price. A put is ITM when its strike is above the stock price.

At the money — The option strike price and the stock price are the same.

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Information on

new books.

Ask questions: rookies (at) mdwoptions (dot) com

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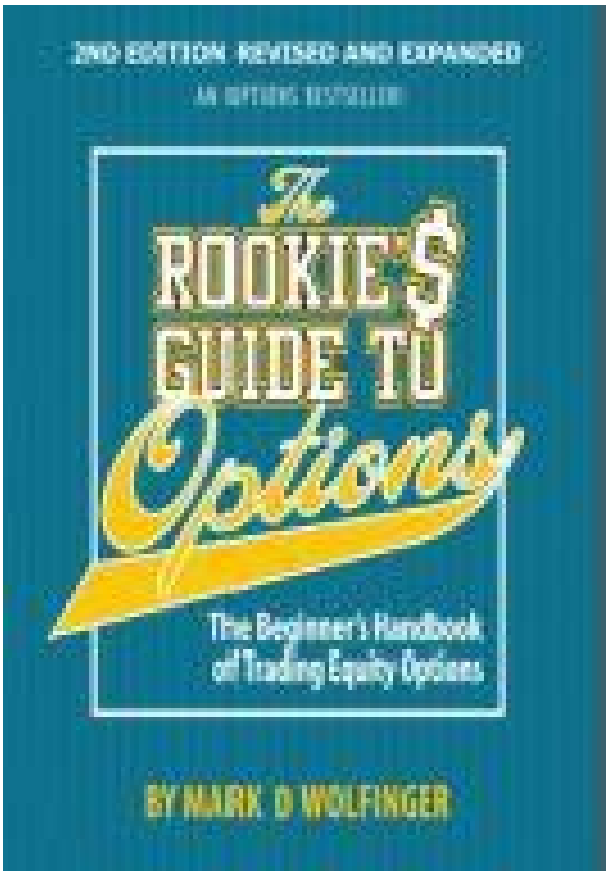
My Dead-Tree Books

The Rookies Guide to Options, 2nd Edition (2013)
Create your own Hedge Fund (2005)
The Short Book on Options (2002)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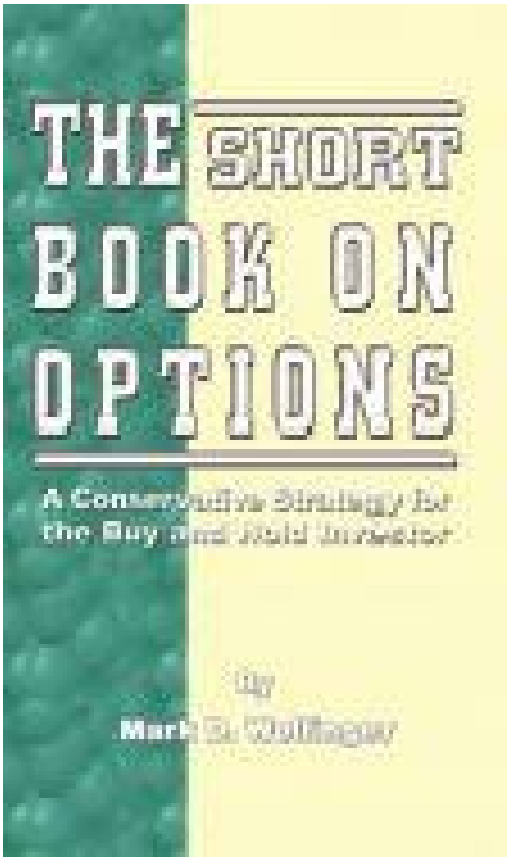
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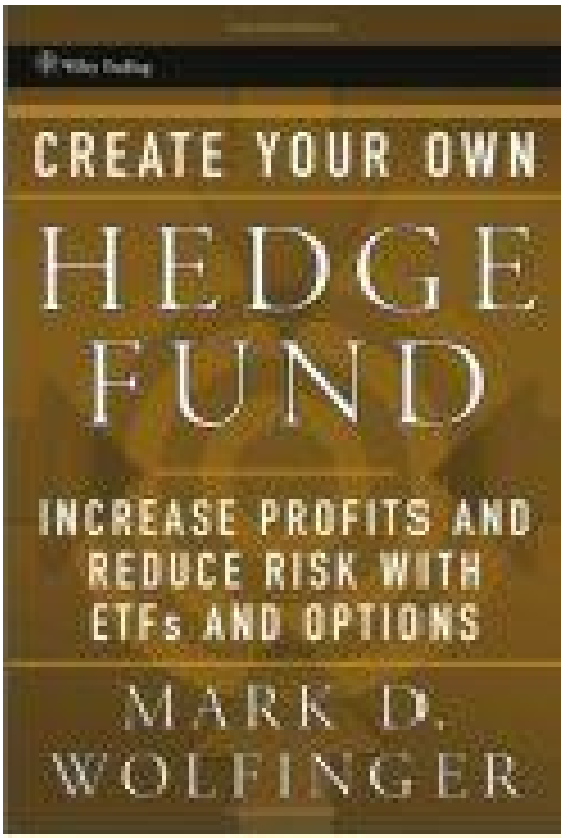
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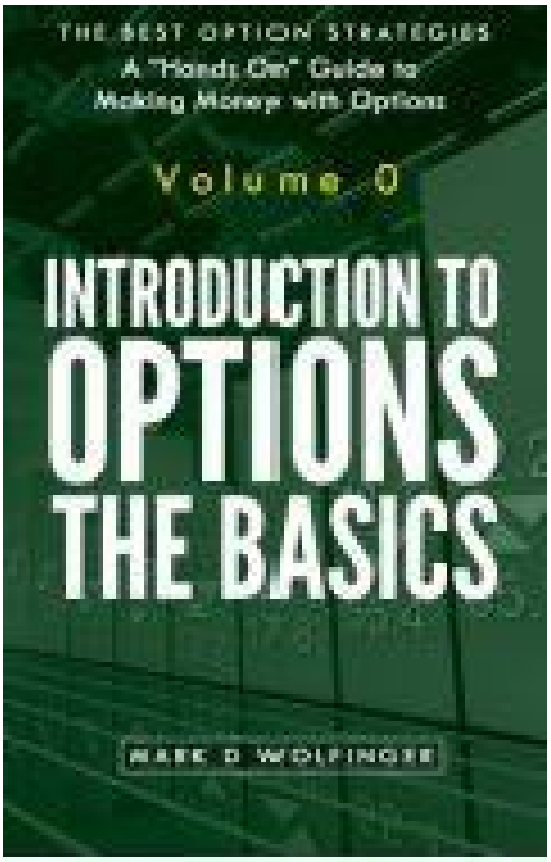

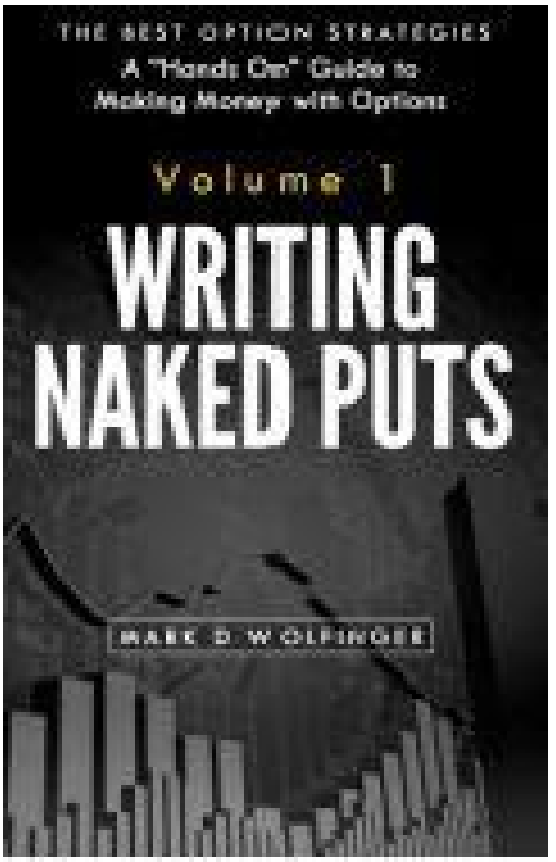

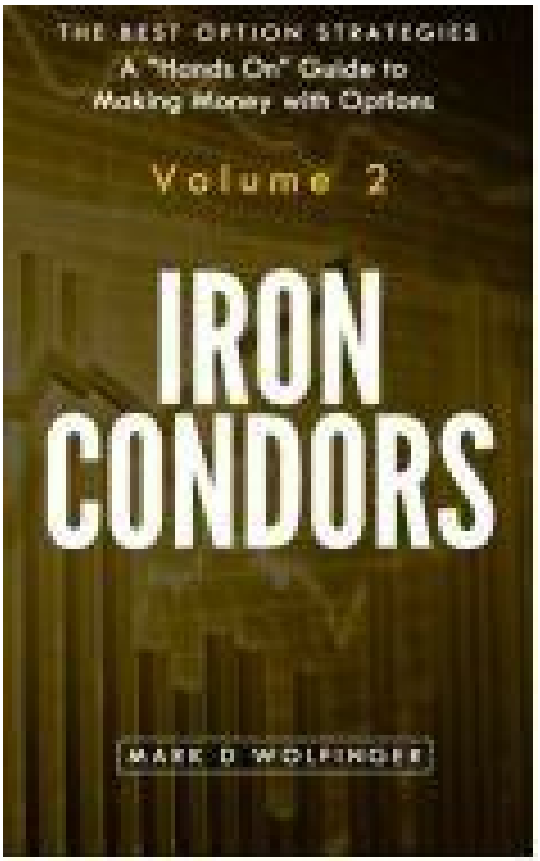
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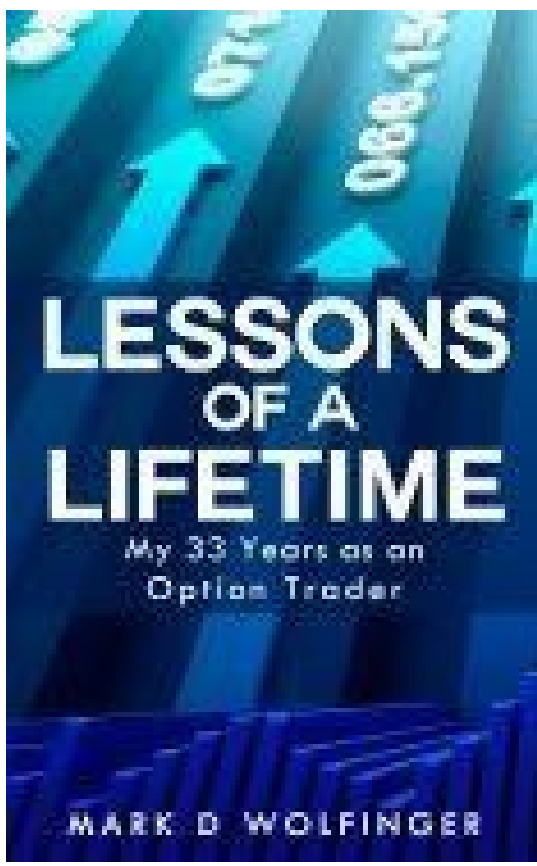

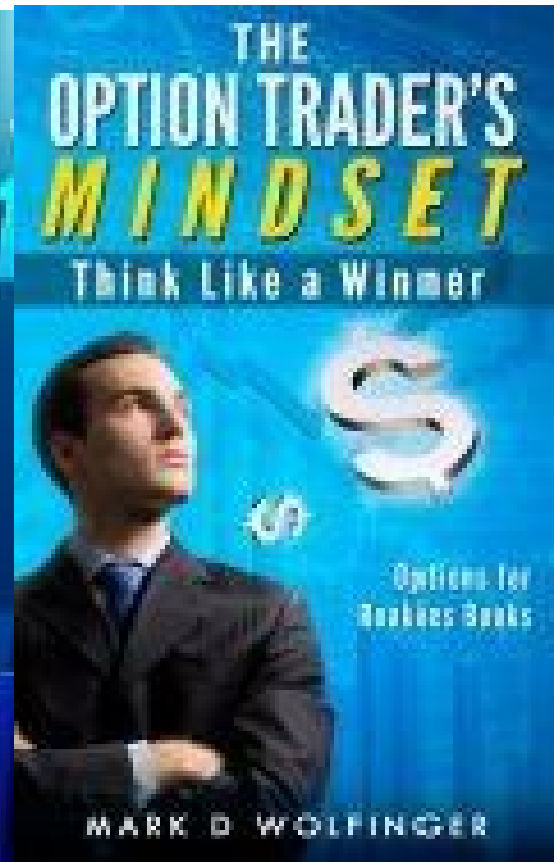

Available at your favorite bookseller.

About the Author

In 1975 I began trading options (writing covered calls) for my own account and two years later became an options professional as a market maker on the trading floor of the Chicago Board Options Exchange (CBOE).

Since mid-2000, I've been teaching individual investors how to adopt risk-reducing, profit-enhancing option strategies.

I've published three dead-tree books and several ebooks.

If you always wanted to learn about options, The Rookie's Guide to Options; 2nd edition is the book for you.

I live in Evanston IL.

Mark Wolfinger

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